Department of Finance

News Release

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Minister of Finance Stands Firm on Tax Fairness for All Canadians

Before a special hearing of the House of Commons Standing Committee on Finance, the Honourable Jim Flaherty, Minister of Finance, today stated that Canada's New Government intends to proceed with the Tax Fairness Plan that was announced October 31, 2006.

"Make no mistake, the decision that was taken on October 31st is all about fairness—fairness in our tax system, fairness for hard-working Canadian taxpayers and their families, fairness for seniors, for business and other levels of government," said Minister Flaherty. "I am not prepared to sacrifice the interests of millions of hard-working Canadians who pay their taxes and play by the rules so that a select group of special interests can enjoy a tax holiday."

Minister Flaherty provided the committee with a detailed accounting of the estimated federal revenue loss of $500 million for 2006 due to the special tax advantage for income trusts—a burden that was unfairly being shifted to ordinary taxpayers and other tax-paying corporations.

The Minister pointed out that extending the 4-year transition period for existing trusts to 10 years would cost the federal treasury approximately $3 billion. It would also cost provincial treasuries. Alberta would lose over $2 billion and Quebec would lose hundreds of millions.

Minister Flaherty noted provincial and territorial governments unanimously supported the Tax Fairness Plan at the December 2006 meeting of federal-provincial-territorial finance ministers in Vancouver given the negative impact of income trusts on provincial revenues and their economies.

"It is regrettable that some investors suffered financial losses," said Minister Flaherty. "Although it was a very difficult decision, it was an absolutely necessary decision for the country and for future generations of Canadians, our children and grandchildren. At the same time, we have proposed to further reduce the general corporate income tax rate, increase the age credit amount by $1,000 and, for the first time ever, allow Canadians to split their pension income beginning this year."

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Minister Flaherty's presentation to the Standing Committee on Finance and other documents related to the Tax Fairness Plan and income trusts can be accessed at http://www.fin.gc.ca/access/truste.html.

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Remarks by the Honourable Jim Flaherty,

Minister of Finance,

to

the House of Commons Standing Committee on Finance

January 30, 2007

Check Against Delivery

Introduction

Good morning.

Mister Chairman and members of the committee, I want to thank you for the opportunity to be here today.

You have received a briefing book with a copy of my statement, a document outlining our revenue estimates and calculations, and a series of charts illustrating the growing trend towards trust conversions and foreign ownership.

I insisted on being the first witness to remind this committee directly of the critical importance of moving forward with our income trust policy and our Tax Fairness Plan.

Make no mistake, the decision that was taken on October 31st is all about fairness.

- Fairness for Canadian taxpayers and their families who would be asked to pay more and more;

- Fairness within the corporate sector, where the current rules give income trusts a tax advantage and distort investment decisions;

- Fairness for Canadian taxpayers, who are seeing tax dollars sent out of the country to foreign investors; and

- Fairness for all Canadian governments, federal and provincial, who are experiencing a significant loss of tax revenue.

I want to take the next few minutes to:

Quickly outline the Tax Fairness Plan;

Walk the committee through the numbers and our methodology. As I indicated in the fall, we estimate the federal revenue loss was about $500 million in 2006 and growing, and this is a conservative estimate.

I will also point out the hundreds of millions of dollars in tax loss to the provinces.

I will talk about the fact that the landscape had changed dramatically with almost $70 billion in trust conversions taking place or being announced in the first 10 months of 2006.

I will also explain why it would be a mistake to carve out the energy sector and provide them with a permanent tax holiday.

And finally, I want touch on the need to maintain a four-year transition period in order to avoid billions more in revenue loss.

Tax Fairness Plan

I want to say from the outset that it is regrettable that some investors suffered financial losses. Although it was a very difficult decision, it was an absolutely necessary decision for the country and for future generations of Canadians, our children and grandchildren.

Our Tax Fairness Plan achieves two critically important goals. It restores balance and fairness in the tax system and strengthens the Canadian economy, now and into the future.

The Tax Fairness Plan achieves these goals through:

- A distribution tax on distributions from publicly traded income trusts with a four-year transition period for existing trusts;

- An additional reduction in the general corporate income tax rate of half a percentage point in 2011;

- An increase in the age credit amount by $1,000 to benefit low- and middle-income seniors; and

- The ability for pensioners to split income beginning this year. Pension income splitting is a major positive change in tax policy for pensioners and seniors. It significantly enhances the incentives to save and invest for family retirement security.

I want to be clear with the members of this committee and with all Canadians. I have no intention of altering the substance of the government's decision, including the four-year transition period for existing trusts.

Canadians are looking for fairness and for certainty. And our Tax Fairness Plan provides both.

An Unfair Burden

I've said it repeatedly as Finance Minister: Canadians pay too much tax. And this government has already taken steps to reduce their tax burden.

Simply ignoring this issue would have resulted in Canadians paying more tax, not less, today and for years to come.

Why? Because, as more and more companies converted to income trusts, they were shifting their corporate tax responsibilities onto the backs of individual taxpayers and their families. There was a growing trend towards corporate tax avoidance.

In fact, in a news release on September 11th, 2006, Robert McFarlane, executive vice president and CFO of TELUS, stated, "TELUS is pursuing a trust conversion at this time since it has recently utilized all of its tax assets and a conversion early in 2007 will optimize its future taxable position."

This wasn't an isolated case, but rather a disturbing trend that was moving into the core of our industrial and knowledge-based economy.

Since we took office, the landscape began to change significantly. In the first 10 months of 2006, almost $70 billion in new income trust conversions took place or were announced. Chart A shows clearly this trend in income trust conversions and the path we were all on.

This represented a clear and present danger to our tax system and our economic structure. Evidence was mounting that we were running a real risk of turning into an income trust economy. An economy where tax avoidance drove business investment decisions and foreign investors stood to make significant gains at the expense of Canadian taxpayers.

No responsible government could stand by and let this happen. It wasn't fair and it wasn't right. Regardless of the political consequences, we had to act. And we did, accepting our responsibility and acting in the best interest of Canada.

As I stated on numerous occasions, we estimate that the federal revenue loss was about $500 million in 2006, as Chart B and the supporting material you have received clearly demonstrates. And we believe this is a conservative estimate.

Now, consider what these calculations don't include.

They don't include any further conversions by any other companies. We estimate that TELUS and BCE alone would have added substantially more to this total.

Widely reported estimates from financial experts based on information from the companies themselves indicated the corporate tax savings over the next two years would have been about $1.3 billion for TELUS and about $1 billion for BCE.

Just imagine what the total would have been had other large corporations, like EnCana or large financial institutions that currently pay billions in corporate income tax, followed suit.

The numbers also don't include provincial tax impacts. During my meeting with provincial Finance Ministers on December 15th, 2006, in Vancouver, they expressed serious concerns about the loss of tax revenue and unanimously endorsed our Tax Fairness Plan.

Letters from the provincial Ministers are included in your package, here are a few examples of what we received:

Carole Taylor, B.C. Minister of Finance, wrote, "I believe the measures you propose are necessary to address the policy and revenue impacts of converting corporations to income trusts....I believe that without action the continued conversions to income trusts would have led to a serious disruption of the tax system."

Manitoba's Minister of Finance, Greg Selinger, said, "Corporations were increasingly under pressure to convert to income trusts solely as a result of tax considerations, even in instances where trusts were not otherwise the most appropriate form of organization."

Michel Audet, the Minister of Finance for Quebec, said it was clear that the advantages enjoyed by income trusts had gone on too long and that action was called for.

Conservative Estimate

Now, some critics have questioned these figures.

In fact, these estimates are very similar to those made by Jack Mintz of the Rotman School of Business, and former president of the C.D. Howe Institute.[1]

On October 19th, 2006, Mr. Mintz said, "It is silly to argue that there isn't any tax loss. Everyone knows the reason people go into income trusts is because there are tax benefits....That's the way the law is."

The methodology used to determine federal revenue loss should also be familiar to the Liberal committee members, since it's the very same methodology their own government used in preparing its 2005 consultation paper.

The revenue loss estimates are based on a sound and consistent methodology, and we stand by them.

These are conservative estimates. The tax loss number could actually be higher.

As Chart C demonstrates, by increasing the effective tax rate by 1 percentage point from 6.6 per cent to 7.6 per cent, the annual revenue impact would jump by over $200 million to $710 million per year.

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[1] Jack Mintz estimated a total federal-provincial revenue impact of $700 million and $1.1 billion including BCE and TELUS. His estimates include REITs, but not limited partnerships. A portion of the estimate relates to future tax revenues from tax-exempt investors ($200 million of the $700 million estimate).

You will no doubt hear from some witnesses that there is no real tax loss and if there were, it would be more than made up in the future through personal income taxes or withholding taxes on foreign investors, or taxes on deferred pension plans or RRSP withdrawals.

Think of what you are being told: give income trusts a definite tax break now but get it back sometime in the future.

As Minister of Finance, I have a fiduciary obligation to the taxpayers of today, not tomorrow. I have an obligation to pay for needed social, environmental and economic programs today, not tomorrow. I cannot and will not fund today's programs from tomorrow's revenues.

Clearly, income trusts had a special tax advantage that regular business corporations did not enjoy. You know it, they know it, and the market knows it.

The market reaction to a policy that levels the playing field between income trusts and corporations—that makes them equal, not worse—shows that a built-in tax advantage existed. Otherwise, the investors would not have reacted the way they did. There would have been no market correction.

And for those who, faced with all of this evidence, still claim that we don't know whether there will be a loss of government revenue from income trusts, all I can say to that is:

- We have federal *and* provincial government estimates that clearly demonstrate tax loss.

- Income trust distributions are being sent out of the country to a large number of foreign investors who are reaping a financial windfall. The only Canadian tax they are required to pay is a 15 per cent withholding tax—far less than the taxes paid by trust holders here in Canada.

- We have had two of Canada's biggest companies explicitly citing tax considerations as the reasons for announcing plans to convert last year.

- We know that these same two companies have since renounced their conversion plans since our announcement that any new trusts would be taxed as corporations.

- We know that other large firms that were actively planning to convert to trusts have abandoned their plans.

- And we know that groups such as the Coalition of Canadian Energy Trusts must realize that there is tax loss—otherwise, they wouldn't argue that the trust structure gives them a lower cost of capital than the corporate model does.

Who Pays

Now, faced with these tax losses, the natural question should be, who will pay for all of this lost revenue?

Your constituents will, of course—the people of Markham–Unionville, the people of Joliette, the people of Winnipeg North, and certainly the people of my riding of Whitby–Oshawa.

By failing to implement the Tax Fairness Plan, we would harm our government's books and affect the budgets of every single province in this country. As I pointed out earlier, they are extremely concerned about this issue.

Why? Because ongoing trust conversions were costing them millions. And they understand that converting our businesses into income trusts is not the way to build a dynamic, competitive economy.

The province of Alberta, for example, estimated in its 2006 budget that it was losing $400 million a year before we introduced our Tax Fairness Plan.

The Atlantic provinces lost one of their biggest corporate taxpayers when BCE converted Aliant into an income trust. This conversion had a significant impact on their corporate tax revenues.

And Quebec has estimated that the province would have lost $150 million annually if the conversions of certain large corporations had proceeded as announced.

How would it be fair that foreigners would reduce their tax bills through this structure, but not hard-working Canadians who pay to keep our schools, hospitals and emergency services running?

The Future Costs

As you can see, the costs of indecision would have been substantial and unfair, not just for our government, but for all governments.

Our Tax Fairness Plan recognizes that investors, many of whom are seniors, have been affected. We are taking steps to protect investors in four key ways:

First of all, we are providing a fair and reasonable four-year transition period before the new distribution tax will apply to existing income trusts.

Secondly, we are providing generous growth guidelines during this transition period, allowing existing income trusts to actually double in size.

Thirdly, we are putting in place this year pension income splitting for seniors and pensioners; a significant improvement to our tax system worth approximately $700 million a year.

And fourthly, we are increasing the age credit amount by $1,000 from $4,066 to $5,066 effective January 1, 2006. This measure will provide tax relief for low- and middle-income seniors.

This committee will be urged to make a recommendation to extend the transition period from 4 to 6, to 8 or even 10 years. I want you to consider the ramifications of such a move. A transition extension is actually a policy reversal. It gets through the back door a policy change you can't get through the front door.

A longer tax holiday period for trusts would just mean tax unfairness for a longer period of time. It would do nothing for some investors who decided to sell their units between November 1st and today.

Most of all, it would create a greater financial burden on Canadian taxpayers. Extending the transition period from 4 to 10 years would cost the federal treasury approximately $3 billion. It would also cost provincial treasuries. Alberta would lose over $2 billion and Quebec would lose hundreds of millions.

So I would say to the Member for Joliette, are you in favour of a wealth transfer of hundreds of millions of dollars from the pockets of Quebec taxpayers by extending the transition period to 10 years?

This isn't how you build a 21st-century economy. This isn't how you build a productive future and a better quality of life for all Canadians, the ultimate goal of our economic plan, *Advantage Canada*.

It certainly isn't how our competitors are doing it—not the U.S., not Australia, not the U.K.

As Peter Godsoe, former Chairman and CEO of the Bank of Nova Scotia said on October 23rd, "We are using a structure that the Americans looked at and shut down. The Australians had trusts, they shut them down. The British looked at this, and decided not to allow it. What do we know that everyone else doesn't?"

Canada's New Government agrees. Watching the world go by will do nothing to help future generations, whose standard of living will be determined by the investments we make today.

Who Should Pay Their Fair Share

Delaying, in other words, only puts off the ultimate goal of this decision—an economy driven by sound business and economic decisions, not by the kind of tax planning and tax avoidance our major competitors have clearly rejected.

Let me deal with one final issue before I take your questions, and that's the effect of our decision on energy trusts in particular.

Some in the energy sector have called for special rules based on the sector's history with these tax vehicles.

I don't agree, and I don't believe most Canadians do either.

I believe it's reasonable to expect that all sectors of the economy pay their fair share of taxes.

Critics have often pointed to the U.S. energy sector and called on our government to treat energy income trusts the same way the U.S. does with Master Limited Partnerships—or "MLPs."

First of all, Canada has no intention of mimicking the U.S. tax code.

Secondly, U.S. MLPs are almost exclusively owned by domestic investors. In Canada, energy income trusts are to a considerable extent foreign-owned. As the chart behind me clearly indicates, foreign ownership rates for large energy trusts are about 50 per cent.

Thirdly, structural impediments under U.S. law have the practical effect of limiting the investment of U.S. mutual funds and tax-exempts in MLPs.

Fourthly, we do not accept that the U.S. MLP rules will provide a tax advantage as compared to Canadian energy trusts, as the tax treatment of taxable investors under both regimes is effectively the same.

And finally, it's important to understand how much more significant the issue with energy trusts is in Canada. The value of Canadian publicly traded energy trusts represents roughly 4 per cent of the TSX market cap. Income trusts alone comprise over 15 per cent of Canadian oil and gas production. In comparison, the total value of U.S. MLPs amounts to less than a third of 1 per cent of the market capitalization of the NYSE and NASDAQ.

And had we not acted, the energy trusts' share of the marketplace would have risen even further. More and more businesses would have asked, why should that company benefit and not mine?

Then, that $500 million revenue loss would grow, because if a company like EnCana opted to become a trust, you can be certain that they would not be alone.

Talk to Newfoundland and Labrador, a province with an historic opportunity before it to build prosperity and lift its citizens out of debt, and see what they would think about Hibernia, for example, becoming an income trust.

This is not a hypothetical illustration. In the case of Hibernia, the federal government has received several proposals to do just that.

As Mr. Marshall, the province's Finance Minister, wrote to me: "The potential erosion of this revenue source resulting from the proliferation of Income Trusts had been of grave concern prior to your announcement."

Newfoundland and Labrador, Nova Scotia and the federal government all believe very strongly that energy projects should pay their fair share of tax.

Our government remains committed to tax fairness and fulfilling our commitment in *Advantage Canada* by lowering taxes further as we prepare our next budget.

Our last budget reduced taxes in 29 different areas. While not giving anything away, I can tell you that, had this government not acted on income trusts, any plans for future tax reductions in the next budget would be at risk.

Conclusion

A few finals thoughts to conclude.

In the end, our government was faced with a hard choice, and now this Parliament is faced with a big decision: to make the Tax Fairness Plan a reality.

We chose not only to recognize a growing problem occurring in Canada's tax system, but to fix that problem.

We made our decision based not on political calculations, as did the previous government, but on principles of tax fairness, balancing the needs of individual investors with the interests of taxpayers and their families.

And we acted responsibly and decisively.

It is not tax fairness if it is only for a few. And it is not strengthening the economy if the playing field is not level for all businesses.

And committee members should recognize that they can't turn the clock back. There has been a substantial change of ownership in trusts since October 31, 2006—for a number of trusts, up to one quarter of the shares have changed hands.

Where there was once speculation as more and more large corporations opted to become income trusts, today there is certainty.

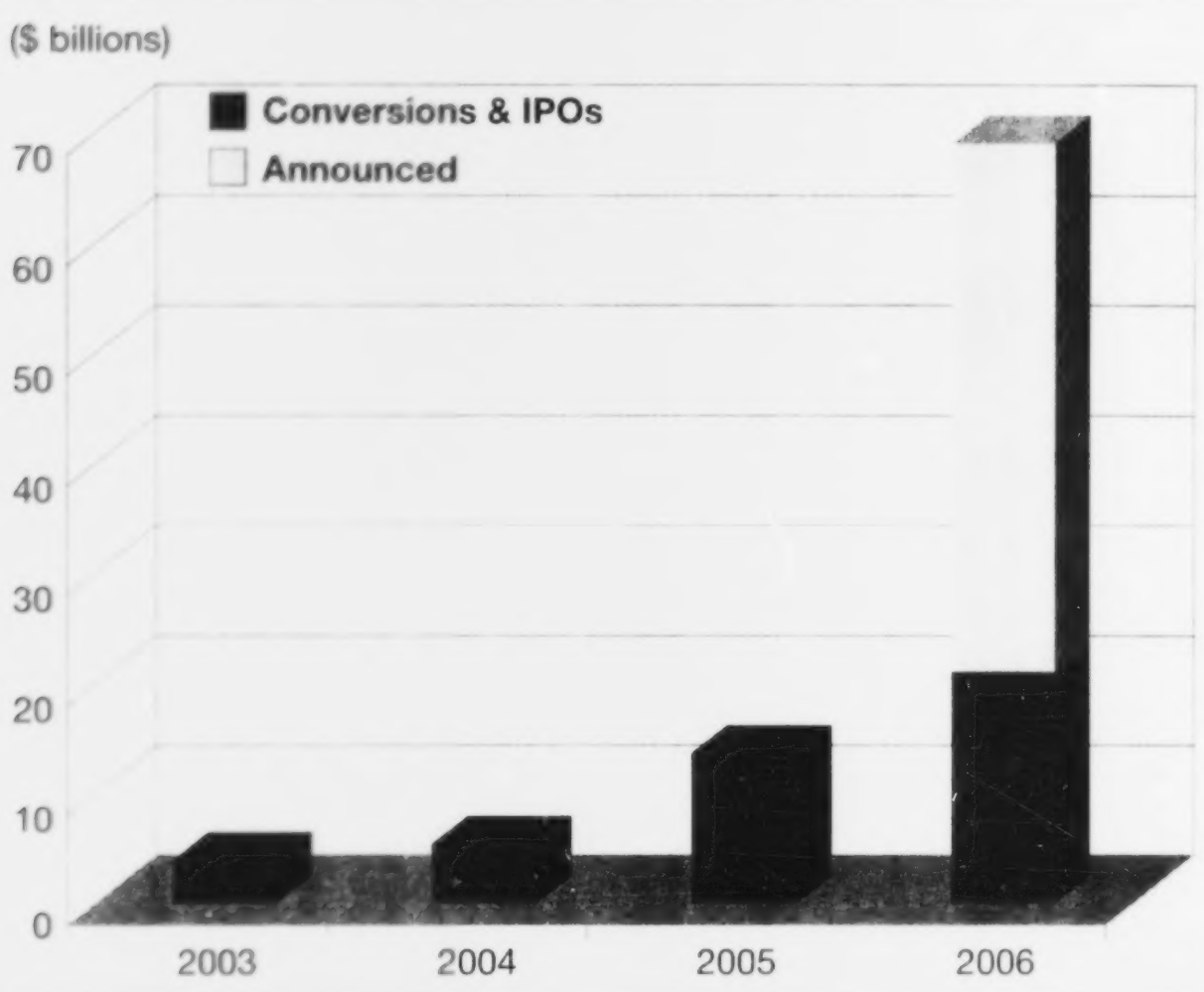
Businesses are making their own choices to grow this economy. They're moving on.

It's time we all move on in the interests of all Canadians.

The result of *our* decision is clear: a tax system that is fairer for Canadians and that will help make our economy more productive, efficient and dynamic today and for years to come.

I would now be pleased to answer any questions you may have.

ACCELERATION OF CONVERSIONS AND IPOs
(INCLUDING BCE AND TELUS)



(A)

FEDERAL GOVERNMENT TAX LOSSES – 2006

$500 Million

	Total ($ millions)
1. Taxes under the FTE structure	
Taxes paid by unitholders/partners	1,500
Taxes paid by third party lenders	175
Total	1,675
2. Taxes under the corporate structure	
Corporate income tax	1,480
Taxes paid by shareholders	485
Taxes paid by third party lenders	310
Total	2,275
3. Ongoing federal tax revenue impact (1 – 2)	–600
4. One-time capital gains tax on conversions and IPOs in 2006	100
Net federal revenue impact (3 + 4)	**–500**

(B)

SENSITIVITY OF ESTIMATED FEDERAL REVENUE LOSS TO KEY ASSUMPTIONS

($ millions, 2006)

Effective Federal Corporate Tax Rate		Proportion Held by Tax-Exempt Investors		
(% EBITDA)*	(% FTE Pre-Tax Profit)**	25%	38%	50%
6.6%	14.2%	255	**500**	705
7.6%	16.4%	460	710	920
8.6%	18.6%	665	915	1,130
10.2%	22.1%	1,005	1,260	1,480

* EBITDA refers to "earnings before interest, taxes, depreciation and amortization."

** FTE refers to "flow-through entities," consisting of publicly-traded business income trusts, energy trusts and limited partnerships.

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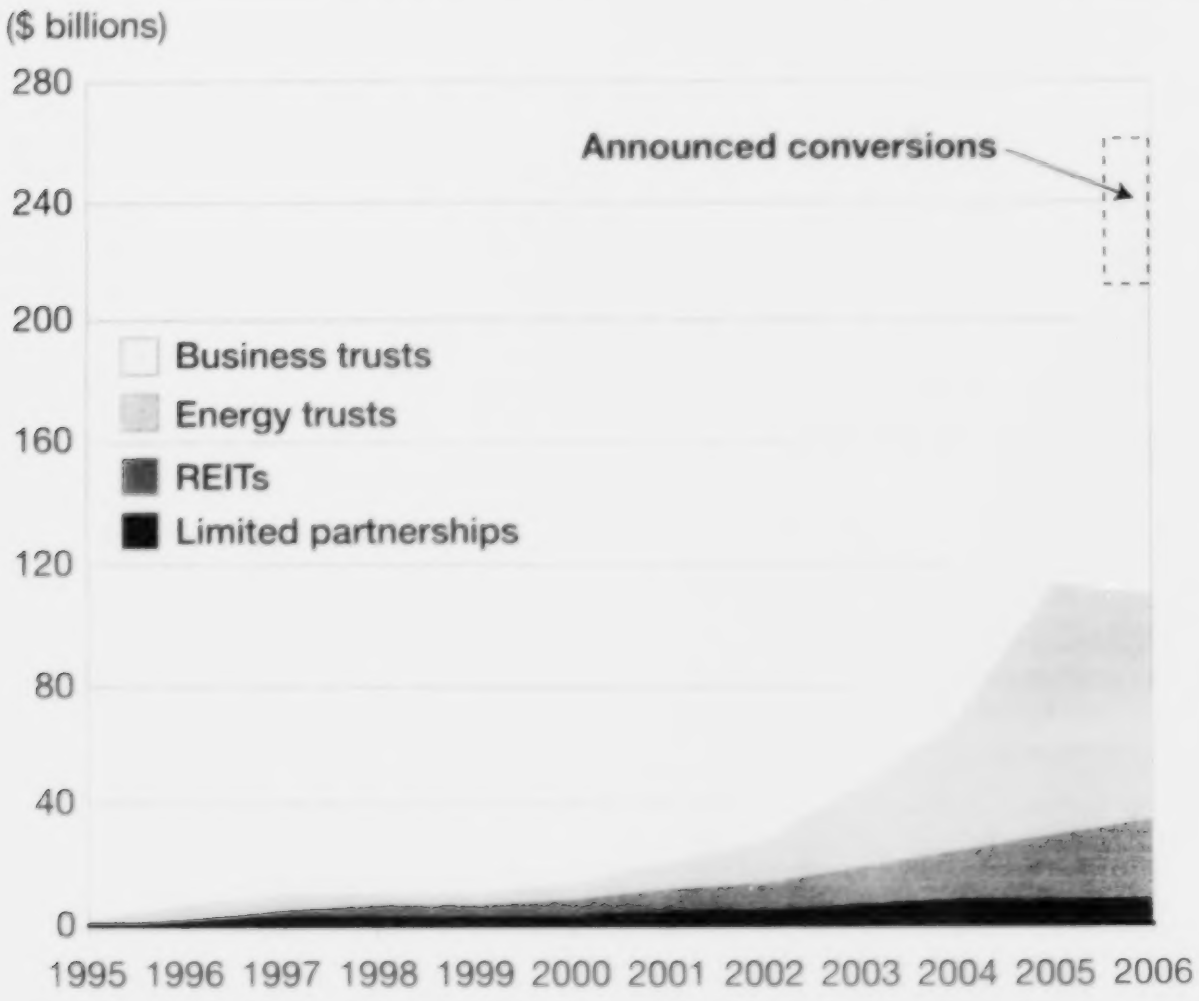
INCOME TRUST AND LIMITED PARTNERSHIP GROWTH

Market Capitalization
1995–2006



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LARGE ENERGY TRUST FOREIGN OWNERSHIP PERCENTAGE

October 2006

Large Trusts	Foreign Ownership Percentage
ARC Energy Trust	35%
Baytex Energy Trust*	38%
Bonavista Energy Trust	23%
Canadian Oil Sands Trust	43%
Canetic Resources Trust*	33%
Enerplus Resources Fund*	70%
Harvest Energy Trust*	50%
Pengrowth Energy Trust*	50%
Penn West Energy Trust*	54%
PrimeWest Energy Trust*	70%
Provident Energy Trust*	85%
Large Energy Trusts Average	**50%**

* Indicates trusts which are also listed in the U.S.

Source: Peters & Co. Limited, Energy Update.

Estimated Federal Revenue Impact from Flow-Through Entities

(Publicly-Traded Income Trusts and Limited Partnerships)

Background Document

Introduction

This document provides background on the estimated impact of flow-through entities (FTEs)—publicly-traded business income trusts, energy trusts and limited partnerships—on federal tax revenues in 2006.

The impact on federal tax revenues is measured as the difference between federal income tax revenues under the corporate structure and the FTE structure.

Under the corporate structure, tax revenues include:

- Corporate income tax paid by the corporation (excluding the federal capital tax that was eliminated after 2005);
- Income tax (including withholding tax) paid by shareholders on corporate dividends and on capital gains upon the disposition of shares; and,
- Income tax paid by third party lenders on interest income received from the corporation.

Under the FTE structure, tax revenues include:

- Income tax paid (if any) by the operating entity and the income trust;
- Income tax (including withholding tax) paid by investors on distributions (or allocations in the case of limited partnerships) and on capital gains on the disposition of the trust units (or partnership interests); and,
- Income tax paid by third party lenders on interest income received from the operating entity or FTE.

The methodology for the federal estimate in this paper is the same as that used in the Department of Finance's 2005 consultation paper[1] and is similar to the revenue loss estimated by Jack Mintz.[2] The methodology used for the estimate in this paper is consistent with the methodology the Department uses for budget and tax expenditure purposes.

The data in this paper reflect the most recent annual financial data for FTEs and corporate data from Statistics Canada and the Canada Revenue Agency (CRA).

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[1] See Department of Finance 2005 consultation paper "Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)". This paper provided the federal revenue impact for 2004.

[2] Mintz's estimate includes real estate investment trusts and excludes publicly traded limited partnerships. His estimate also includes provincial taxes and an estimate of the future tax effect from tax-exempt investors. See Jack Mintz, "Income Trust Conversions—Estimated Federal and Provincial Revenue Effects," *Canadian Tax Journal*, 2006, Volume 54, Issue Number 3. Also see Lalit Aggarwal and Jack Mintz, "Income Trusts and Shareholder Taxation: Getting It Right," *Canadian Tax Journal*, 2004, Volume 52, Issue Number 3.

Financial Data for FTEs

The estimates in this paper are based on financial data from FTEs in 2005. They do not include FTEs that are U.S. businesses. In 2005, FTEs reported earnings before interest, taxes, depreciation and amortization (EBITDA) of $18.3 billion and distributions of $10.3 billion. On average, 77 per cent of distributions are characterized for tax purposes as ordinary income, 3 per cent as taxable dividends and 20 per cent as capital gains.

Financial statements of FTEs are not yet available for the 2006 fiscal year. Consequently, 2005 financial statement data are used for the 2006 estimate. The growth in the average FTE market capitalization for 2006 is used as a general proxy for the growth of EBITDA in 2006 since there was a virtual match in the growth of EBITDA and average market capitalization in 2005. As a measure of prudence, it is assumed that the increase in EBITDA in 2006 was only 75 per cent of the increase in average market capitalization as of October 2006.

Financial Data under the Corporate Structure

CRA and Statistics Canada data are used to estimate the financial structure of FTEs if they had been structured as corporations. This data is used to estimate the interest payments to third party lenders, dividends paid to shareholders, capital gains that would accrue to shareholders and corporate income taxes paid. All of these are expressed as a percentage of EBITDA in the Annex. Interest expenses, dividends and capital gains have been updated from the 2005 consultation paper.

An important parameter under the corporate structure is the federal corporate income tax that would have been paid by the FTE if it had been structured as a corporation. The average effective tax rate used for FTEs is 6.6 per cent, expressed as a percentage of EBITDA. This translates to the equivalent of a statutory tax rate of 14.2 per cent, of before-tax profit of FTEs. As indicated in the 2005 consultation paper, using effective corporate tax rates based on data from CRA and Statistics Canada understates the loss in federal corporate tax revenues because it includes small businesses paying a lower rate of tax and corporations with little or no taxable income (such as growing businesses or start-ups). It also understates the revenue loss to the extent that corporations put proportionately more of their mature business assets (i.e. income-producing assets) into FTEs—for example, where a resource corporation divides its resource business into an income-producing FTE and an exploration company.[3]

The estimates in this paper are also conservative because the effective federal corporate income tax rate applicable to energy trusts is not increased even though oil prices (West Texas) increased 65 per cent from 2004 to 2006, substantially increasing profits. This effect more than offsets the impact of the 15 per cent decrease in the federal corporate income tax rate for resource corporations (the statutory rate decreased from 28.12 per cent in 2004 to 24.12 per cent in 2006) and the resource allowance changes.

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[3] Corporate income taxes that would have been paid on income from mature business assets are understated using an average effective federal corporate income tax rate on all the assets of the corporation due to the higher expenses related to the growing part of the business.

Investors

The distribution of investors used in this paper is the same as in the 2005 consultation paper—taxable Canadian investors are assumed to hold 38.6 per cent of FTE units, tax-exempt investors (i.e. pension funds and RRSPs/RRIFs) 38.8 per cent and non-residents 22.6 per cent.[4]

The average federal personal income tax rate for Canadian taxable investors is 25 per cent, which is calculated using CRA data on individual taxpayers that reported dividend income. The federal personal income tax rate on dividends for the 2006 estimate takes into account the enhanced dividend tax credit that was announced in the 2006 budget. The personal tax rate on capital gains is 12.5 per cent (50 per cent inclusion rate and 25 per cent personal income tax rate).

Capital Gains Tax on Conversions and IPOs

When a corporation announces that it is converting its business or spinning off part of its business into an FTE, the value of its shares (if publicly-traded) can increase in value principally due to the total tax savings under the FTE structure. The increase in value will vary across businesses depending on the potential tax savings. On average, these estimates assume that the increase in share price is about 15 per cent (or approximately 13 per cent of the total value of the conversions and IPOs).[5] This increase in share price can give rise to a one-time increase in capital gains tax revenue.

In 2006, conversions and IPOs valued at $69 billion were announced, with $21.1 billion having proceeded as of October 2006—the value of conversions and IPOs was up from $13.7 billion in 2005 and $5.5 billion in 2004. The estimated one-time federal capital gains tax payable by taxable Canadian investors takes into account some conversions having been structured to defer the capital gains tax (e.g. through exchangeable shares). It is assumed that one-third of the federal capital gains tax accruing in 2006 is deferred to future years.

Estimated Impact on Federal Revenues in 2006

The federal revenue loss due to FTEs in 2006 is estimated to be $500 million, taking into account the deferral opportunities with the capital gains tax as noted above.

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[4] The average distribution of investors across all FTEs is different than those reported in the 2005 consultation paper because the estimates in this paper do not include real estate investment trusts.

[5] The premium is based in part on a study by Paul Halpern, *Is the Trust in Trusts Misplaced*, Rotman School of Business, University of Toronto, pages 28-31, November 2004.

The federal revenue loss for 2006 is composed of a $600 million ongoing revenue loss, broken down as follows:

- Business income trusts accounted for $295 million;
- Energy trusts accounted for $260 million; and,
- Limited partnerships accounted for $45 million.

Offsetting this ongoing revenue loss are one-time federal capital gains taxes accruing as a result of the $21.1 billion of conversions and IPOs in 2006. The estimated total value of one-time federal capital gains tax accruing in 2006 that is attributable to Canadian taxable investors is $155 million—with $55 million (about one-third) deferred to future tax years. Consequently, the net federal revenue impact for 2006 is $500 million, after taking into account the $100 million of capital gains tax that was not deferred from 2006.

Table 1. Estimated Impact on Federal Income Tax Revenues (*)
($ millions, 2006)

	Business Income Trusts	Energy Trusts	Limited Partnerships	Total
1. Taxes under the FTE structure				
Taxes paid by unitholders/partners	685	760	55	1,500
Taxes paid by third party lenders	105	45	25	175
Total	790	805	80	1,675
2. Taxes under the corporate structure				
Corporate income tax	675	730	75	1,480
Taxes paid by shareholders	255	200	30	485
Taxes paid by third party lenders	155	135	20	310
Total	1,085	1,065	125	2,275
3. Ongoing federal tax revenue impact (1 – 2)	-295	-260	-45	-600
4. One-time capital gains tax on conversions and IPOs in 2006	100	0	0	100
Net federal revenue impact (3 + 4)	**-195**	**-260**	**-45**	**-500**

(*) There are provincial losses as well. In its 2006 budget, Alberta estimated its revenue loss at $400 million annually.

Sensitivity of Estimate to Key Parameters

The revenue estimates are sensitive to several key parameters, such as the growth in market capitalization, the effective federal corporate tax rate and the distribution of investors. As indicated in the previous sections, the federal revenue loss is conservatively estimated.

As mentioned earlier, a measure of prudence is added because FTE financial data for 2006 were not available. EBITDA is increased by only 75 per cent of the growth rate in the average market capitalization in 2006. Relaxing this assumption would increase the ongoing revenue loss (line 3 in Table 1) by about $35 million.

The prudence built into the estimate of the loss of federal corporate tax (using an effective federal tax rate which is likely well below the actual rate) is potentially very significant. If the effective tax rate is increased 1 percentage point, from 6.6 per cent to 7.6 per cent, the revenue impact would increase from $500 million to $710 million. If before-tax profits reported by FTEs were used as a proxy for taxable income, then the estimated federal revenue loss would be $1,260 million in 2006.

Since March of 2006, many of the largest FTEs have been listed on the S&P/TSX Composite Index (accounting for about 10 per cent of the index). As a result, pension funds may invest more in FTEs, which could increase the proportion of FTEs held by tax-exempt investors. If the proportion of FTEs held by tax-exempt investors were 50 per cent, the estimated federal revenue loss would be $705 million for 2006.

Table 2 below shows the sensitivity of the estimated impact on federal tax revenues to these two key assumptions.

Table 2. Sensitivity of Estimated Federal Revenue Loss to Key Assumptions ($ millions, 2006)

	Effective Federal Corporate Rate		Proportion of FTEs Held by Tax-Exempt Investors		
	(% EBITDA)	(% of FTE Pre-tax Profit)	25%	38%	50%
1	6.6%	14.2%	255	500	705
2	7.6%	16.4%	460	710	920
3	8.6%	18.6%	665	915	1,130
4	10.2%	22.1%	1,005	1,260	1,480

Projecting Future Tax Revenues from Tax-Exempt Investors

Some commentators argue that the federal estimate overstates the federal revenue loss because the estimate does not include future income tax revenues from pension funds and RRSPs/RRIFs. While pension funds and RRSPs/RRIFs do not pay income tax (they are tax-exempt), it is possible that pensioners and RRSP/RRIF holders could pay additional income tax in the future as a result of increased investment returns on their registered plans.

When calculating revenue impacts, the federal government takes into account the costs relating to the year in question. Under this well-accepted and appropriate approach to calculating revenue impacts, tax revenues from pensioners and holders of RRSP/RRIF accounts realized in the future would be included in revenue estimates for those future years.

In addition, it is very difficult to predict future tax revenues because the timing of pension income and RRSP/RRIF withdrawals, as well as the amounts of these incremental earnings, is not known.

It is important to note that, even for these future years, only the incremental earnings from the income trust investment over and above that would have been earned had the entity been in corporate form would be included in the revenue estimate for these years.

Annex: Summary of Parameters (2006)

Parameters	Business Trusts	Energy Trusts	Limited Partnerships	Total
Financial statements data[1]				
EBITDA ($M)	9,890	11,566	1,090	22,546
Interest expenses – third party ($millions)	1,124	509	263	1,896
Interest expenses (% EBITDA)	11.4%	4.4%	24.1%	8.4%
Distributions ($ millions)	6,238	5,898	635	12,771
Distributions (% EBITDA)	63.1%	51.0%	58.2%	57.3%
Distributions – taxable	75.0%	83.6%	38.6%	77.2%
Distributions – dividends	5.4%	0.1%	9.2%	3.1%
Distributions – tax-deferred distributions	19.7%	16.3%	52.2%	19.8%
Distribution of investors[2]				
Taxable Canadian – retail	40.0%	27.6%	40.0%	34.3%
Taxable Canadian – mutual funds	5.0%	3.9%	5.0%	4.5%
Non-residents	10.0%	37.5%	10.0%	22.7%
Tax-exempt	45.0%	31.0%	45.0%	38.5%
Distribution of third party lenders[2]				
Taxable Canadian – retail	12.0%	12.0%	12.0%	12.0%
Taxable Canadian – institutional	13.0%	13.0%	13.0%	13.0%
Non-residents	29.0%	29.0%	29.0%	29.0%
Tax-exempt	46.0%	46.0%	46.0%	46.0%
Federal personal tax rates[3]				
Interest	25.0%	25.0%	25.0%	25.0%
Dividends	8.7%	8.7%	8.7%	8.7%
Capital gains	12.5%	12.5%	12.5%	12.5%
Non-resident tax rates[4]				
Trust – taxable distributions	15.0%	15.0%	25.0%	15.5%
Dividends	15.0%	15.0%	15.0%	15.0%
Trust – Tax deferred distributions	0.0%	15.0%	0.0%	6.9%
Interest	10.0%	10.0%	10.0%	10.0%
Corporate structure (% EBITDA)[5]				
Federal corporate income tax	6.8%	6.3%	6.8%	6.6%
Federal and provincial corporate tax	11.1%	8.8%	11.1%	10.0%
Interest expenses – third party	17.2%	12.5%	17.2%	15.0%
Dividends	19.7%	9.0%	19.7%	14.8%
Capital gains on shares[6]	26.4%	25.1%	34.3%	26.2%

[1] Financial data on FTEs can be found on the SEDAR website (www.sedar.com). Virtually all of the FTEs are listed on the Toronto Stock Exchange. The data on the tax treatment of distributions is from financial statement data of FTEs and from CIBC World Markets, "2005 Tax Report: Summary of 2005 Distributions Tax Treatment" (Exhibits 4 and 5).

[2] The distribution is the same as that used in the Department of Finance 2005 consultation paper.

[3] The average federal personal income tax rate for taxable Canadian investors is 25 per cent. This effective tax rate is calculated using Canada Revenue Agency data on individual taxpayers that reported dividend income. The effective federal personal income tax rate on dividends in 2004 and 2006 was 14.6 per cent based on a 125 per cent gross up of dividends and a 13.33 per cent dividend tax credit (i.e., 1.25 * (25.0 – 13.33)). The personal income tax rate on dividends in 2006 is reduced to 8.7 per cent (i.e., 1.45 * (25.0 – 19.0)) as a result of the enhanced dividend tax credit in the federal 2006 budget.

[4] The withholding tax rate of 15 per cent is based on the Canada-U.S. tax treaty. Non-resident partners of Canadian publicly-traded limited partnerships are subject to Canadian income tax. The withholding tax on dividends under the Canada-U.S. tax treaty is 15 per cent. As a result of the 2004 budget, the withholding tax on tax deferred distributions of mutual fund trusts that have resource or real property are subject to a 15 per cent withholding tax under the Canada-U.S. tax treaty. The withholding tax on interest payments under the Canada-U.S. tax treaty is 10 per cent.

[5] Federal and provincial corporate taxes (as a percentage of EBITDA) is an average for the 2000 to 2003 period using Statistics Canada data, Catalogue no. 61-219-XIE, *Financial and Taxation Statistics for Enterprises*, 2003. In the case of energy trusts, data from the Canada Revenue Agency is used. These rates were reduced to take into account the reductions in the federal corporate income tax rate since then. Interest expenses and corporate dividend distributions (as a percentage of EBITDA) are from Statistics Canada, Catalogue no. 61-008-XIE, *Quarterly Financial Statistics for Enterprises*.

[6] The estimate for capital gains accruing annually to shareholders is based on the estimated increase in value of the corporation net of interest payments to third party lenders, corporate income taxes, and dividends paid to shareholders.

FAXED Jan 29/07 HG.

ALBERTA
MINISTER OF FINANCE

AR#17337

January 29, 2007

Honourable James Flaherty
Minister of Finance
Government of Canada
21st Floor, East Tower
L'Esplanade Laurier
140 O'Connor Street
Ottawa ON K1A 0G5

Dear Mr. Flaherty:

This is further to our conversation regarding revenue losses to Alberta from income trusts. As you know, there was a statement in Alberta's 2006 budget that Alberta's net revenue loss due to income trusts is about $400 million annually; we now believe the estimate is $450 million.

Sincerely,

Lyle Oberg, M.D.
Minister of Finance

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Elizabeth Kingston
Clerk of the Finance Committee
House of Commons Committees Directorate
180 Wellington Street
Ottawa ON K1A 0A6

Dear Ms. Kingston:

Thank you very much for your invitation to appear before the Standing Committee on Finance on Tuesday, January 30, to discuss income trusts. I regret that I am unable to appear before the Committee.

I would like the Committee to know that, in principle, the Government of Ontario supports the federal government's efforts to ensure fair taxation through changes to the tax treatment of income trusts. We believe that these changes will protect federal and provincial revenue from significant tax leakage.

Ontario supports federal transitional rules as they appear to be flexible enough to allow trusts to proceed with reasonable growth, while ensuring there is no unfair advantage over the transition period. Ontario also supports the federal move to allow trusts to convert back to corporations without any tax consequences to investors on such conversions and welcomes the creation of a working group on the allocation of the new distribution tax. Consultation on federal tax changes that affect provinces and territories is essential.

Thank you once again for the invitation and for giving me the opportunity to share Ontario's position on income trusts with the Standing Committee.

Yours sincerely,

Greg Sorbara
Minister

c. The Honourable Jim Flaherty
Minister of Finance (Canada)

209351

Québec

Gouvernement du Québec
Le ministre des Finances

Québec, le 25 janvier 2007

L'honorable James Flaherty
Ministre des Finances
Finances Canada
L'Esplanade Laurier, Tour Est, 21e étage
140, rue O'Connor
Ottawa (Ontario) K1A 0G5

Cher collègue,

La présente fait suite à la décision du comité permanent des finances de tenir prochainement des audiences à l'égard du nouvel impôt visant les entités intermédiaires, communément appelées les fiducies de revenu.

Je tiens à vous réitérer l'appui du gouvernement du Québec à l'égard des modifications relatives à la fiscalité des entités intermédiaires qui ont été annoncées le 31 octobre dernier dans votre *Plan d'équité fiscale*. Les objectifs visés par ces changements rejoignent les orientations de notre gouvernement en ce qui a trait à la mise en place d'une fiscalité équitable et neutre qui assure à toutes les entreprises les mêmes possibilités dans l'accès au financement et dans la poursuite de leurs objectifs de croissance. Pour nous, il était évident que l'avantage dont disposaient les entités intermédiaires persistait depuis trop longtemps et qu'il était nécessaire que des gestes soient posés.

Déjà, à l'automne 2005, je communiquais avec votre prédécesseur pour lui faire part des inquiétudes du gouvernement du Québec à l'égard de la popularité grandissante des fiducies de revenu et des impacts potentiels qu'elles présentaient pour l'économie canadienne. Des représentants du ministère des Finances du Québec ont également rencontré des représentants de votre ministère pour leur faire part de nos préoccupations. Pour l'essentiel, nous mentionnions alors que les distorsions dans les choix d'affaires des entreprises, en raison de l'iniquité fiscale existante, ne pouvaient être justifiées et qu'il fallait agir pour corriger le biais favorable à l'utilisation des entités intermédiaires qui leur permet de se soustraire de l'impôt des sociétés.

... 2

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Il était cependant important qu'une période de transition soit mise en place. Vous avez bien compris cette préoccupation et les modalités que vous proposez à cet égard sont satisfaisantes.

C'est pourquoi nous appuyons sans réserve la période transitoire de quatre ans qui est actuellement annoncée, à savoir l'application dès 2011 des nouvelles règles pour les entités intermédiaires existantes. La prolongation de la période transitoire ne pourrait qu'accroître les pertes fiscales des gouvernements et faire perdurer l'iniquité du régime fiscal applicable aux entreprises.

À ce propos, bien que le Québec ait jusqu'à présent été relativement épargné par les pertes fiscales liées aux conversions de sociétés en entités intermédiaires, les conversions annoncées par certaines grandes sociétés plus présentes au Québec auraient porté ces pertes à 150 millions de dollars annuellement, lesquelles auraient inévitablement dû être assumées par les autres contribuables québécois.

Je tiens à vous rappeler que notre soutien aux nouvelles règles des entités intermédiaires s'est traduit par l'annonce, en décembre dernier, de l'intention claire du gouvernement du Québec d'harmoniser la législation fiscale québécoise aux règles qui seront édictées à cet égard dans la législation fiscale fédérale.

En terminant, je salue à nouveau le courage dont vous avez fait preuve dans le traitement de ce dossier et vous prie d'agréer, cher collègue, l'expression de mes sentiments les meilleurs.

MICHEL AUDET

[TRANSLATION]

Gouvernement du Québec
Le ministre des Finances

Québec, January 25, 2007

The Honourable James Flaherty
Minister of Finance
Finance Canada
L'Esplanade Laurier, East Tower, 21st floor
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear colleague:

I am writing further to the Standing Committee on Finance decision to hold hearings shortly on the new tax on flow-through entities, commonly known as income trusts.

I want to reiterate the Quebec government's support for the flow-through entity taxation amendments announced on October 31, 2006 in your *Tax Fairness Plan*. The purpose of these amendments corresponds to our government's directions in setting up fair, neutral taxation that puts all businesses on a level playing field in obtaining access to financing and pursuing their growth objectives. In our opinion, it was clear that the advantages enjoyed by flow-through entities had gone on too long and that action was called for.

Already, in the fall of 2005, I contacted your predecessor in order to express the Quebec government's concerns about the increasing popularity of income trusts and their potential impact on the Canadian economy. As well, representatives of Quebec's Ministère des finances met with representatives of your Department to share our concerns. The main point, as we then indicated, is that the distortions in business decisions caused by inequitable taxation could not be justified, and that action was called for to correct the bias favouring the use of flow-through entities and allowing them to avoid corporate tax.

That being said, it is important that there be a transition period. You have clearly understood this concern, and the rules you propose in this regard are satisfactory.

That is why we unconditionally support the four-year transition period announced at present, that is, the application of the new rules governing existing flow-through entities starting in 2011. Extending the transition period could only increase governments' tax losses and perpetuate inequitable business tax treatment.

.../2

In this regard, although until now Quebec has largely been spared tax losses resulting from conversions of corporations to flow-through entities, the conversions announced by certain large corporations that are more prominent in Quebec would have increased these losses to $150 million annually, a loss that would have fallen on other Quebec taxpayers.

I wish to note once again that our support for the new rules governing flow-through entities resulted in the December 2006 announcement of the Quebec government's clear intention to harmonize Quebec tax legislation with the federal tax legislation rules to be enacted in this regard.

In closing, I again salute the courage you have shown in addressing this issue.

Yours truly,
[signed]
Michel Audet

Prince Edward Island
CANADA

Provincial Treasury **Trésor de l'Î.-P.-É.**

Île-du-Prince-Édouard
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Bureau du Ministre - Minister's Office
JAN 30 2007

January 26, 2007

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
L'Esplanade Laurier
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Minister Flaherty:

I am writing to express my support for your new Tax Fairness Plan as announced on October 31, 2006 and the transition guidance provided on December 15, 2006. Specifically, I would like to reaffirm that I strongly agree with the changes that were announced regarding the tax treatment of income trusts including the proposed four-year transition period for already existing trusts.

I have previously shared my concerns with you over the announcement by Bell Canada Enterprises last March to form a new telecommunications income trust which includes the telephone and internet land-line operations of Aliant Inc. Aliant was a major corporate taxpayer in Prince Edward Island and since the income trust structure allows for a complete elimination of taxable corporate profits, my province is losing a substantial amount of revenue from just this one conversion. And unlike the federal government which will recover some of that lost corporate tax revenue from increased personal income tax revenues, we will not be so fortunate. This is a result of the fact that a majority of the unit holders of the new income trust reside in provinces outside of our own.

Prior to your announcement October 31st, I was also rather concerned that this particular deal was only the beginning of a more serious regional income trust problem. If other major corporate taxpayers in this province and region decide to follow Aliant's lead, we could find ourselves facing a severe tax base decline. The federal actions taken in November of 2005 by the previous federal administration were inadequate to address the interprovincial tax consequences arising from income trusts. However, the new Tax Fairness Plan has addressed these concerns as well as providing substantial tax relief to seniors. I fear that to back-track or alter your income trust tax proposals as announced in October would be very damaging to our efforts to build a strong, self reliant corporate tax base in P.E.I. as well as in the Atlantic region in general.

Sincerely,

Mitch Murphy

Mitch Murphy
Provincial Treasurer of Prince Edward Island

January 26, 2007

The Honourable James Flaherty
Minister of Finance
Government of Canada
Ottawa, Canada
K1A 0G5

Dear Minister Flaherty:

I am writing to you to confirm the position of the Government of Newfoundland and Labrador in relation to the issue of the taxation of Income Trusts. My predecessor, the Honourable Loyola Sullivan, had previously written you, commending you on making the difficult but necessary decision to tax Income Trusts. As you recall, Minister Sullivan reiterated this province's support for the initiative in the Finance Ministers meeting in Vancouver.

Despite the strong negative reaction from the financial markets, we have not wavered in our views on taxing income trusts. We believe that the transitional provisions for existing Income Trusts are fair and reasonable. We have seen no need to adjust the transition period.

As you are aware, the energy sector in Newfoundland and Labrador has grown significantly over the last few years, and has potential to provide significant fiscal returns to the people of this province and to the Government of Canada. The potential erosion of this revenue source resulting from the proliferation of Income Trusts had been of grave concern prior to your announcement. We support your government's decision to apply the new rules to Energy Trusts.

I believe it is important for your government to stay the course on this issue, and I look forward to passage of legislation to implement your proposal.

Yours sincerely,

THOMAS W. MARSHALL, Q.C.
Minister of Finance and
President of Treasury Board

BRITISH COLUMBIA

January 26, 2007

169383

The Honourable James M. Flaherty, PC, MP
Minister of Finance
Government of Canada
House of Commons
Ottawa ON K1A 0G5

Dear Honourable Flaherty:

As Minister of Finance for the Province of British Columbia, I am writing in support of your proposed changes to the federal *Income Tax Act* that impact the tax treatment of income trusts.

I believe the measures you propose are necessary to address the policy and revenue impacts of converting corporations to income trusts. As you note in your October 31, 2006 announcement of the Tax Fairness Plan, there has been an increasing cost in terms of income tax revenues as a result of these conversions. In addition, the conversion of income trusts can result in shifts of tax revenues among provinces and shifts in tax burden among taxpayers. I believe that without action the continued conversions to income trusts would have led to a serious disruption of the tax system.

The measures you propose are appropriate and do provide fair transitional rules for existing income trusts and clear rules for new trusts.

In closing, I would like to thank you for taking the necessary steps to address this issue.

Sincerely,

Carole Taylor.

Carole Taylor
Minister of Finance

pc: Brian Pallister, Chair, Standing Committee on Finance, MP Portage-Lisgar

MINISTER OF
FINANCE

Legislative Building
Winnipeg, Manitoba, CANADA
R3C 0V8

JAN 2 6 2007

Ms. Elizabeth B. Kingston
Clerk for The Standing Committee on Finance
House of Commons
673 – 180 Wellington Street
Ottawa ON K1A 0A6

Dear Ms. Kingston:

The Province of Manitoba supports the proposal of the Government of Canada to improve the neutrality of the tax system by adopting more equal treatment of corporations and flow-through entities such as income trusts. It is important for the efficient functioning of our economy that business decisions be based on commercial considerations, and not be driven by opportunities for tax arbitrage. Because of differences in tax treatment, corporations were increasingly under pressure to convert to income trusts solely as a result of tax considerations, even in instances where trusts were not otherwise the most appropriate form of organization.

We were also concerned that income earned by non-resident investors in income trusts was escaping taxation altogether. The proposed federal changes address this problem.

The four-year delay in adopting the new tax regime is both reasonable and fair. We note that pensioners, some of whom were invested in income trusts, have received an offset in the form of pension income splitting for tax purposes. Manitoba has confirmed that this measure will apply for purposes of provincial income tax as well. Manitoba was also one of the first provinces to announce that it would parallel the federal increase in the dividend tax credit on dividends distributed by corporations that are not eligible for the small business deduction. The higher dividend tax credits have also helped to create more equal treatment of income from corporations and flow-through entities.

Manitoba hopes that members of the Committee will be able to support the proposed changes.

Sincerely yours,

Greg Selinger

Greg Selinger

cc: The Honourable James Flaherty

NOVA SCOTIA
Finance
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Docs #: 50966

January 30, 2007

The Honourable James M. Flaherty
Minister of Finance
Government of Canada
L'Esplanade Laurier
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Minister Flaherty:

I am writing to confirm my support for your Government's policy and corresponding Bill regarding taxation treatment of Income Trusts. We believe that potential substantial conversion by Canadian corporations to these structures would be detrimental to the interests of Nova Scotians by reducing the tax revenues on which we depend in order to provide the services that they require.

We further support your intent to apply this new treatment to all forms of business including the energy sector. As you are aware, Nova Scotia expects continued development of our offshore resources and considers it important to our ongoing economic growth. The taxation policy that you plan to effect is consistent with these objectives, and the four year timeline presents ample opportunity for industry to adapt to these new provisions.

Please continue to pursue your intention to pass the requisite legislation.

Yours truly,

Michael G. Baker, Q.C.
Minister